

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: Arambula Analyst: Raul Guzman Bill Number: AB 2924
Related Bills: See Legislative History Telephone: 845-4624 Introduced Date: February 24, 2006
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Qualified Capital Expenditures & Qualified Capital Investments Credit/Depreciation Deduction/Environmental Protection/Energy Independence And Climate Mitigation Investment Act Of 2006

SUMMARY

This bill would create three new tax credits for taxpayers that incur certain capital expenditures and also permits accelerated depreciation of the expenditures.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to offer a comprehensive set of incentives to encourage businesses to reduce greenhouse gases.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2007, and would apply to taxable years beginning on or after that date.

POSITION

Pending.

ANALYSISFEDERAL/STATE LAW

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in the production of income or property used in a trade or business. The amount of this deduction is determined, in part, by the cost (or basis) of the property. In addition, the property must have a limited, useful life of more than one year. Expenses for purchasing property with a useful life in excess of one year must be capitalized and depreciated over the recovery period of the property, rather than deducted in the year purchased or acquired.

Board Position:

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_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director

Date

S. Stanislaus

5/18/06

Depreciable property includes equipment, machinery, vehicles, and buildings, but excludes land. Significant improvements to property (i.e., those that meet the standard described in the preceding paragraph) are added to the basis of the property and are depreciated over the property's remaining useful life.

Previous state law allowed qualified taxpayers a Manufacturers' Investment Credit (MIC) equal to 6% of the qualified costs paid or incurred on or after January 1, 1994, and before January 1, 2004, for qualified property that was placed in service in California.

For purposes of the MIC, a qualified taxpayer was any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property was any of the following:

- 1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used in a qualified SIC Code activity, that is used primarily for:
 - manufacturing, processing, refining, fabricating, or recycling of property;
 - research and development;
 - maintenance, repair, measurement, or testing of otherwise qualified property; or
 - pollution control that meets or exceeds state or local standards.
- 2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.
- 3) Special purpose buildings and foundations that are an integral part of specified activities.

For taxpayers engaged in computer programming and computer software-related activities, qualified property included computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excluded certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

The MIC statute was repealed by its own terms and ceased to be operative as of January 1, 2004, due to the number of manufacturing sector jobs in California no longer meeting the MIC statutory requirements.

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

THIS BILL

This bill would allow the following three new credits under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL):

1. This bill would provide a 15 percent credit for amounts paid or incurred for qualified capital expenditures and defines the following terms:
 - “Qualified capital expenditures” are an engine, boiler, or generator that measurably reduces greenhouse gas emissions from a qualified facility.
 - “Qualified facility” is an existing facility or an expansion of an existing facility of the taxpayer, and the expansion is in the same location or adjacent to an existing facility of the taxpayer.

2. This bill would provide a 10 percent credit for amounts paid or incurred for qualified capital investments and defines the following term:

“Qualified capital investments” are equipment used to produce, generate, or store renewable energy from biomass, solar, wind, and hydrogen sources.

This bill would deny anyone who takes the qualified research expense credit or the qualified capital investment credit from claiming other renewable energy technology credits.

3. This bill would provide a 15 percent credit for amounts paid or incurred for qualified research expenses and defines the following terms:
 - “Qualified research expenses” are expenses for research, approved and selected by the California Energy Commission under the Public Interest Energy Research Program, on renewable energy technologies.
 - “Renewable Energy Technologies” means technologies that generate energy from biomass, solar, wind, and hydrogen.

This bill would deny anyone who takes the qualified research expense credit or the qualified capital investment credit from claiming other renewable energy technology credits.

This bill would allow all three unused credits to be carried over indefinitely.

In addition to the three credits mentioned above, this bill would allow taxpayers to elect to depreciate the entire cost of any qualified capital expenditures and any qualified capital investments over three years using the straight-line method of depreciation, beginning in the year the cost is paid or incurred and the following two years.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The bill is silent about whether the property must be purchased "new" or whether used property would also qualify. Because the credit and the deduction is not limited to new property, the original use of which commences with the taxpayer, taxpayers could sell the property among affiliates and, absent any kind of recapture provision, continually generate new credits and application of the special depreciation rules provided under this bill. The author may wish to add a recapture mechanism that requires the taxpayer to use the qualified property for a minimum time period in order to be able to qualify for the credit and the enhanced depreciation deduction and may also want to consider requiring that the qualified property be "new" property.

Most credits and deductions relating to acquisitions of a capital asset subject to depreciation require the asset to be "placed in service" in order to qualify for the credit or deduction. This bill allows the credit and the deduction for "costs paid or incurred." Placing the property in service ensures that the asset will be utilized and prevents a taxpayer from moving the expenditure among affiliates in order to generate new credits and applying the special depreciation rules multiple times for the same expenditure.

If it is intended that leasing transactions involving qualified capital expenditures or qualified capital investments would qualify for this bill's provisions, it is suggested that the bill provide rules regarding leased assets or transactions.

This bill would allow a credit for "qualified capital expenditures" such as an engine, boiler, or generator that measurably reduces greenhouse gas emissions from a qualified facility, but does not define by how much such engine, boiler, or generator must reduce the greenhouse gas emissions.

TECHNICAL CONSIDERATIONS

This bill would limit a taxpayer to only this credit for all expenditures incurred for renewable energy technology. Generally credits are enacted to require taxpayers, when expenditures qualify for more than one credit, to make an election limiting the taxpayer to one credit with respect to each qualified expenditure. The author may wish to amend the language to reflect other credit specifications.

Existing law provides a research credit based on the credit available under federal law. It is unclear how the author intends the disallowance to work if a portion of the existing credit could be considered a credit for "renewable energy technology."

LEGISLATIVE HISTORY

AB 2553 (Arambula, 2005/06) would allow a credit for amounts paid for qualified capital expenditures and allow a taxpayer to depreciate those qualified capital expenditures over three years. This bill is currently waiting assignment in the Assembly.

AB 2595 (Arambula, 2005/2006) would allow a taxpayer to depreciate qualified manufacturing equipment. This bill is currently waiting to be assigned to an Assembly Committee.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved but are anticipated to be minor.

This bill would require a calculation for the credit that would require a new form or worksheet to be developed. As a result, this bill would impact the department's printing, processing, and storage costs for tax returns. The additional costs will be identified and, if needed, an appropriation will be requested as the bill moves through the legislative process.

ECONOMIC IMPACT

Revenue Estimate

The estimated revenue losses from this bill are as follows:

Estimated Revenue Impact of AB 2924 Effective Tax Years BOA 1/1/2007 Assumed Enactment Date After 6/30/06 (\$ in Millions)			
Credit	2006-07	2007-08	2008-09
15% capital expenditures	-\$205	-\$1,130	-\$1,670
10% capital investment	-\$140	-\$800	-\$1,210
15% research expenses	Minor loss less than \$500,000	-\$1	-\$2
Total	-\$345	-\$1,930	-\$2,882

This estimate does not consider the possible changes in investment activity, employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This bill would authorize a tax credit equal to 15% of qualified capital expenditures. For the legislative year 2005-06 the California Air Resources Board had requested that a \$1 billion bond be placed on the ballot. The bond funds were to provide an incentive fund for the upgrading of equipment to meet air pollution regulations. The incentive was to be 10% of the cost of the equipment. The Air resources board estimated that the total cost of the capital expenditure for all California business at \$10 billion. This bill would provide a tax incentive of 15% for the same capital expenditure. The air resources board estimated that the \$1 billion in incentive funds would be expended over the next ten years. Using those same assumptions for the tax credit provided by this bill it is estimated that the revenue impact would be a \$150 million loss annually for

California only. The estimate has been tripled to \$450 million because the bill does not exclude expenditures outside California from qualifying.

This bill would also allow a taxpayer to take a deduction for depreciation with respect to those qualified capital expenditures over a 3-year period. The changes in the depreciation schedule for \$1 billion dollar annual investment by businesses (\$10 billion / 10 years) is estimated to reduce revenues by \$225 million the first year, \$370 million the second year and \$570 million the third year for California only. The estimates have been tripled to \$675 million, \$1.1 billion and \$1.7 billion because the bill does not exclude expenditures outside California from qualifying. The estimates presented in the table above reflect fiscal year revenue losses.

This bill would provide a 10% credit for qualified capital investment, which is defined as equipment used to produce, generate, or store renewable energy from biomass, solar, wind, and hydrogen sources. Based on data from the Energy Commission, it is estimated that \$800 million will be annually invested in energy sources that would qualify under this provision for the tax credit. Based on this estimate, \$80 million annually in tax credits would be claimed under this provision. The estimate has been tripled to \$240 million because the bill does not exclude expenditures outside California from qualifying.

This bill would also allow a taxpayer to take a deduction for depreciation with respect to those qualified capital investments over a 3-year period. Changes in the depreciation schedule for \$800 million dollar annual investment by businesses is estimated to reduce revenues by \$175 million the first year, \$290 million the second year and \$450 million the third year for California only. The estimates have been tripled to \$525 million, \$870 million and \$1.4 billion because the bill does not exclude expenditures outside California from qualifying. The estimates presented in the table above reflect fiscal year revenue losses.

This bill would provide a 15% credit for research expenses approved and selected by the California Energy Commission under the Public Interest Energy Research Program on renewable energy technologies. The California Energy Commission currently has a grant program of \$12 million annually to fund research in this area if that funding were match by the industry the revenue impact of this tax credit would be \$1.8 million annually. The estimates presented in the table above reflect fiscal year revenue losses.

LEGAL IMPACT

If this bill requires employers to be located within or residents of California in order to qualify for this credit, the credit may be subject to constitutional challenge. The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738, that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. This case is now pending with the U.S. Supreme Court. The Court will issue its decision on this case by the end of June, 2006. Although the outcome of this decision and its affects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

ARGUMENTS/POLICY CONCERNS

This bill does not contain a sunset date for any of the three credits. Sunset dates generally are provided to allow periodic review by the Legislature.

This bill does not limit the number of years for the carryover period for any of the three credits. Without such a limit, the department would be required to retain the carryover on the tax forms indefinitely. Recent credits have been enacted with a carryover limitation since experience shows credits are typically used within eight years of being earned.

This bill would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation due to the enhanced depreciation deduction.

LEGISLATIVE STAFF CONTACT

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